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STATE PASS OPIC:DZAHNISER AND RMOSBACHER, JR.
USDOC FOR 4530/ITA/MAC/IIRTF/SHAMROCK

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TAGS: [ECON](#) [ETRD](#) [EFIN](#) [EINV](#) [EAID](#) [OPIC](#) [IZ](#)

SUBJECT: SCENESETTER FOR OPIC PRESIDENT AND CEO MOSBACHER'S
VISIT TO IRAQ

REF: BAGHDAD 148

Classified By: Economic Minister Charles Ries for reasons 1.4 (b) and (d).

¶1. (C) Welcome to Iraq. Despite sustained senior level economic engagement with Iraqis during the period of the security surge, security gains have not been cemented in place with jobs and investment. Much is required on many levels to make this happen.

Major Barriers to Investment

¶2. (C) Four obstacles to investment are emblematic of much broader questions. First is the absence of effective financial intermediation in the middle market where retail banks and their customers -- the average Iraqi -- live. Second is the continued absence of a legal and regulatory framework within which investors can make decisions of risk and return with any degree of confidence.

¶3. (C) Third, Government of Iraq (GOI) decision makers are for the most part preoccupied with questions of security -- personal, communal, sectarian, and political -- as are their ostensible constituents. The grinding daily repetition of violent death, even at the much reduced rates of the last several months, makes it difficult to conclude that Iraq is a country that is "open for business" outside the ultra-lucrative oil and telecommunications sectors. A fourth significant barrier is a knee-jerk default setting within the GOI for statist solutions to economic questions.

A Greater State Role
in Mortgage Lending?

¶4. (SBU) You have asked to meet with officials of the Trade Bank of Iraq (TBI) to discuss a proposal to enter into a partnership with TBI to establish a pilot program to provide long term mortgage financing. We understand that the outlines of this facility would include an OPIC capitalization on the order of \$100 million, contingent upon matching funds from the GOI; an additional GOI contribution in the form of subsidies aimed at creating affordable loan-to-income ratios for the borrowers; lending would be in dollars, with a probable target market of GOI employees.

¶5. (C) Such a facility raises questions on several fronts. First, there is an already existing Iraqi Housing Fund (IHF) that operates through the Ministry of Construction and Housing, originally capitalized at \$200 million with upwards of \$80 million still available. We should be careful about creating new, additional state-centric solutions to Iraq's

problem of a severe lack of financial intermediation.

¶6. (C) Second, lending in dollars undermines the Iraqi dinar and the Central Bank of Iraq's (CBI) monetary policy. The CBI loses income from seigniorage, and its policy to reduce dollar circulation is actively undercut. The on-going depreciation in dollar cross-rates, and the CBI's policy of dinar appreciation results in the lending bank experiencing balance sheet losses. The lending bank takes on exchange risk as borrowers will repay in dinars; because the Iraqi institution has low dollar liabilities (deposits), the bank must take long open dollar positions without suitable hedging instruments.

¶7. (C) Third, TBI has no presence in retail lending, and no staff trained for this kind of activity. The Coalition Provisional Authority created TBI for the primary mission of issuing letters of credit for cross-border trade. TBI has no core banking system, and is not branched well throughout Iraq. The Central Bank of Iraq (CBI) -- the banking regulatory body -- has expressed concern over the quality of TBI's monthly accounting reports; Ernst and Young has been unable to complete TBI's 2006 audit, with the knock-on effect that the 2007 audit is blocked as well. Also problematic are concerns that TBI operations suffer from a lack of transparency that has led to suggestions that some activities would not stand up well to sustained legal scrutiny. One example has been TBI's use to increase the bank's capital of interest accrued from Development Fund for Iraq (DFI) funds deposited for letters of credit -- in direct contravention of a CPA order that required the TBI to return the interest. These issues should be addressed, if possible, in your talks with the TBI.

¶8. (SBU) Fourth, the establishment of one or more public institutions in the mortgage market risks having at least a marginal crowding-out effect on the development of effective private retail banking. Mortgage assets derived from Iraq's only significant employee base -- its two million strong government workers -- should be highly attractive to private banks, and provide a strong incentive to them to work hard in attracting the deposits necessary to generate those assets. An OPIC-financed facility that cherry-picks that clientele would play a part in further delaying the development of effective retail financial intermediation in Iraq; Iraqi implementation therefore will need to be closely monitored, and any matching funds contingency perhaps should include provisions to encourage utilization of private sector financial intermediation.

Are There Private Banks?

¶9. (C) To be certain, there are several prior conditions that must be met before existing private banks are in a position to pursue borrowers. There are significant market distortions in the housing and construction sector that have deterred investors in this regionally lucrative industry. It will take more than good lending terms to convince the middle market of Iraqi salary earners to routinely deposit funds into banks -- and keep them there as savings that can be lent on. The creation of GOI-backed deposit insurance is certainly a necessary, though not sufficient, element. Potential depositors must develop confidence in the banks themselves, finding some reason to believe that they will be sufficiently liquid to meet access to funds needs. Such confidence might be bolstered if the public were to believe that the banking regulatory system is robust and effective. The CBI is expected to have a new regulatory framework in place by July 2008 (in keeping with performance criteria under Iraq's IMF Stand-by Arrangement). Unfortunately, the track record of the CBI has been not to enforce any regulation other than the reserve requirement. It is possible that OPIC involvement, correctly executed, could help Iraqi officials to take needed steps to fill this regulatory gap.

Investment Climate: Iraq Is Not
Yet Open for Business

¶10. (SBU) The status of Iraq's legislative framework governing investment remains today as characterized in our January 2008 Investment Climate Statement for Iraq (reftel). The GOI's Council of Representatives (CoR) passed a National Investment Law in October 2006, and the law was published in the Official Gazette as Law No. 13 of 2006 on January 17, 2007. The National Investment Commission (NIC) has not yet been formed, nor has the CoR confirmed a Chairman of the commission. Implementing regulations have been written but are not yet approved nor promulgated. Thus, the law is not in force, nor the chairman of its commission in place: Iraq does not have a legal basis on which investors may call to understand the terms under which investments may be made. This absence of legal framework obviates any hope of recourse through the courts should some instance of Iraqi governance challenge an investor's activities, militating for international arbitration clauses in most cases, at the minimum. Similarly, Iraq has no tariff regime in place that might encourage investment (other than an across-the-board 5 percent 'reconstruction levy'). A fully articulated tariff schedule is in the works as part of Iraq's WTO accession process, but there's no indication that it will be debated in the Council of Representatives or implemented anytime in the near future.

¶11. (SBU) You have asked to meet with the most recently nominated NIC Chairman, Dr. Ahmed Ridah. He is seen as having a great deal of regional experience in attracting foreign investment, but he has not yet been confirmed by the appropriate Iraqi authorities (in particular the Council of Representatives). This has not stopped the OECD from signing an MOU on technical cooperation with him, nor the USG in various instances from accepting his word that he has the full backing of the Prime Minister to engage the GOI and its resources at his discretion.

¶12. (C) We stress, however, that decisions made by or agreements with Dr. Ridah cannot be considered to have legal force. Even if he were eventually confirmed it is questionable whether any prior decisions or agreements in which he were to have been involved would be retroactively validated unless the question is specifically addressed by the confirmation process. Nominated in the first week of

December 2007, Dr. Ridah now stands as having waited longer for confirmation than any of the two prior nominees for the job (who withdrew their candidacies when their confirmation hearings failed to make it onto the CoR's agenda).

State-Owned for Now

¶13. (C) We are seeking a meeting for you with Minister of Industry and Minerals Fawzi F. Hariri, whose responsibilities include the preparation of state-owned enterprises (SOEs) for investor participation. His 2005-2007 attempt to groom 13 companies for joint venture agreements based on production sharing schemes resulted in three cement factories finding strategic partners in January 2008. Two of these agreements have been finalized; the third has fallen through in the last stages of negotiations. Hariri has compiled a new list of some 50 SOEs looking for partners; the ministry's brochure states that the prospective investor would "take control of production, sales, and company management" -- but not ownership, or even significant equity positions, nor even the right of first refusal if privatization were to eventually happen. Problems endemic to SOEs include inability to obtain or generate adequate electricity, lack of fuels of all sorts, prohibitively expensive inputs, and the unlikelihood that the products they produce can compete anywhere against highly competitive low-cost producers in the world market. The only market for many Iraqi SOE products is the GOI itself, and then only if the GOI were to decide to purchase uncompetitively priced goods as an employment generator. GOI

officials speak of plans for eventual privatization -- but no timeline is given that would seem to include the foreseeable future.

Uncertainty
Means Risk

¶14. (C) The security climate in Iraq underwent a significant shift during the period from August 2007 through March 2008. Putting aside the debate as to whether the catalyst was the USG's security surge, or decisions taken by Iraqi sectarian and tribal leaders, or a combination of the two, it is clear that incidences of violence of virtually all types fell. And yet insurgent, sectarian, and political violence has not stopped, claiming between 700 and 2,500 Iraqis per month for the same period. Indeed, there has been a sharp increase in casualties among Iraqis since March 25. Such violence has a paralyzing effect on investment in productive industry. While some firms are expressing initial interests in investing in Iraq, it is not yet clear that the potential returns on investment outweigh Iraq's risks.

COMMENT

¶15. (C) Aggressive investment promotion in Iraq seems premature, absent GOI ability to focus sufficiently on issues other than personal, communal, sectarian, and political security to address questions of the implementation of their legislation, the establishment and enforcing of robust bank regulation, and the embracing of a truly private sector approach to restructuring or closing SOEs. If the USG is going to itself be an investor, it should invest in ways that have a reasonable prospect of encouraging development of sustainable, private sector enterprises. It should not further empower those within the GOI keen to have the public sector displace such businesses. END COMMENT.

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